

Office of Chief Counsel  
Internal Revenue Service  
**memorandum**

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to:  
Senior Attorney (      Group 2,      )  
(Large Business & International)

from:  
Branch Chief, Branch 6  
(Financial Institutions & Products)

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subject:

This Chief Counsel Advice responds to your request for assistance regarding the treatment of Taxpayer's issuance of Exchangeable Debentures and holdings of X Stock under an exception to the straddle rules. Previously we provided assistance to you under POSTF-103007-12, WLI05 with respect to the same transaction, concluding that Taxpayer's debentures and stock were subject to the straddle rules under sections 1092 and 263(g) of the Internal Revenue Code. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =  
Date 1 =  
X =  
a =  
b =  
c =  
d =  
e =  
Year 1 =

## ISSUES

1. Whether the Exchangeable Debentures or the exchange features embedded in the Exchangeable Debentures constitute call options for tax purposes.
2. If the Exchangeable Debentures or the embedded exchange features constitute call options for tax purposes, whether they are “qualified covered call” options for purposes of section 1092(c)(4).

## CONCLUSIONS

1. Neither the Exchangeable Debentures nor the exchange features embedded in the Exchangeable Debentures constitute call options for tax purposes.
2. Even if the Exchangeable Debentures or the exchange features constitute call options, they are nevertheless not qualified covered call options for purposes of section 1092(c)(4).

## FACTS

This memorandum incorporates by reference the facts and analysis provided in the prior memorandum issued under POSTF-103007-12, WLI05.

For purposes of this memorandum, the relevant facts are as follows. On Date 1, Taxpayer issued two tranches of Exchangeable Debentures with a year terms. The debentures were publicly traded and contained exchange features that permitted holders to surrender the debentures at any time in exchange for a fixed number of shares of X Stock, or their cash value, at the choice of Taxpayer. At the time they were issued, the principal amount of the debentures was equal to approximately b percent more than the value of the shares that they referenced.

Taxpayer treated the debentures as contingent payment debt instruments (“CPDIs”) for tax purposes and accrued interest on the debentures under the noncontingent bond method of section 1.1275-4(b). Holders received a current coupon on the debentures at their stated rates of either c% or d%, and were required to accrue interest at the comparable yield of e% on the debentures under section 1.1275-4(b)(3).

Taxpayer had a right to redeem the debentures for their principal amount plus a premium and any accrued interest, depending on when they were redeemed. If Taxpayer called the debentures for redemption, holders were permitted to surrender their debentures and exercise their exchange rights.

Taxpayer deposited the minimum number of shares required to satisfy its exchange obligation in an account with an Exchange Agent. Taxpayer retained the right to ordinary dividends and voting rights in the X Stock but was limited in its ability to use the stock, such as pledging or hypothecating it. If the minimum required number of shares in the account were not maintained, then the holders had the right to call the debentures for early redemption and receive back their principal and accrued interest amounts,

regardless of the fair market value of the stock. Taxpayer was also required to give the holders the benefit of certain extraordinary dividends and notify the holders of certain events that could affect the value of the stock.

Our prior assistance to you concluded that Taxpayer's issuance of the debentures and the X Stock constituted a straddle under section 1092 and that interest and repurchase premium paid with respect to the debentures upon their redemption in Year 1 were to be capitalized into the basis of the stock under section 263(g).

You now ask whether the Exchangeable Debentures or the exchange features embedded in the debentures constitute qualified covered call (QCC) options such that the transaction is subject to section 1092(c)(4) and thus exempt from the straddle rules of section 1092 and 263(g).

### LAW AND ANALYSIS

A straddle consists of offsetting positions with respect to personal property. Section 1092(c)(1). Section 1092(c)(4)(A) provides an exception for certain straddles consisting of qualified covered call options and the optioned stock. In general, if (i) all the offsetting positions making up any straddle consist of 1 or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and (ii) such straddle is not part of a larger straddle, such straddle shall not be treated as a straddle for purposes of section 1092 and section 263(g).

1. Neither the Exchangeable Debentures nor the exchange features embedded in the Exchangeable Debentures constitute call options for tax purposes.

Under section 1092(c)(4)(B), in order for either the Exchangeable Debentures or the exchange features embedded in the debentures to constitute "qualified covered call" options, either the Exchangeable Debentures or the exchange features must be call options for tax purposes.

A call option provides the writer of the option with a premium in return for the obligation to sell specified property at a specified price on or before a specified time period. Rev. Rul. 58-324, 1958-1 C.B. 279; Rev. Rul. 78-182, 1978-1 C.B. 265. Conversely, the holder of the call option pays a premium in exchange for the right – but not obligation – to purchase the property at that same price. Rev. Rul. 58-324. The premium paid by the holder is a nondeductible capital expenditure that is only taken into account upon termination of the option, by failure to exercise or otherwise with resultant gain or loss. Rev. Rul. 58-324; Rev. Rul. 78-182; section 1234(a)(1). The premium received by the writer is not currently included in income but is carried in a deferred account until (1) the writer's obligation expires through the passage of time, (2) the writer sells the underlying stock pursuant to the exercise of a call, or (3) the writer engages in a closing transaction. Rev. Rul. 58-324; Rev. Rul. 78-182; section 1234(b)(1).

An option can be issued in conjunction with a debt instrument. Section 1273(c)(2) provides rules in the case of any debt instrument and an option, security, or other property issued together as an investment unit. Section 1273(c)(2)(A) provides that the issue price for such unit shall be determined in accordance with the rules of this subsection and subsection (b) as if it were a debt instrument. Section 1273(c)(2)(B) provides that the issue price determined for such unit shall be allocated to each element of such unit on the basis of the relationship of the fair market value of such element to the fair market value of all elements in such unit. Section 1273(c)(2)(C) provides that the issue price of any debt instrument included in such unit shall be the portion of the issue price of the unit allocated to the debt instrument under subparagraph (B).

The Exchangeable Debentures are not options for tax purposes. In the instant case, at all times of which we are aware, Taxpayer has treated, and the Service has not challenged, the Exchangeable Debentures as debt instruments that are CPDIs under section 1.1275-4. Taxpayer issued the Exchangeable Debentures in exchange for its obligation to repay a principal amount either in cash or in a fixed amount of X Stock, thus the holders are to receive the greater of their principal amount or the value of the referenced X Stock.

The embedded exchange features are not separable from the Exchangeable Debentures and thus are not options. Taxpayer has not treated the embedded exchange feature as a property right separate from CPDIs nor has Taxpayer treated the exchange feature as an option. Taxpayer has not asserted that any amount attributable to the value of the embedded exchange feature is a “premium” that is treated as a capital amount received for writing a call option for purposes of Rev. Rul. 58-324, Rev. Rul. 78-182, or section 1234. The Exchangeable Debentures were not treated as investment units under section 1273(c)(2), nor has the Service sought to treat the Exchangeable Debentures as a straddle position under section 1092(d)(3)(B)(i)(I)(pre 2004-amendment), which includes as “personal property” for purposes of the straddle rules any stock which is part of a straddle at least 1 of the offsetting positions of which is an option with respect to such stock or substantially identical stock or securities.

For purposes of section 1273, an investment unit consists of a debt instrument issued in connection with a separate warrant or option. Although economically similar, a debt instrument with embedded option features is not treated as an investment unit (i.e. a separate debt instrument and option) for federal income tax purposes. See § 1.163-3(a)(2) (examples (1)-(3) distinguishing convertible debt instruments from investment units); Rev. Rul. 88-31, 1988-1 C.B. 302 (investment unit comprised of common stock and a contingent payment right with respect to the stock were separate items of property because they were separately tradable). Thus, treating the embedded exchange features in the Exchangeable Debentures as qualified covered call options for section 1092 purposes would require us -- contrary to other rules found in the Code and regulations -- to bifurcate the Exchangeable Debentures into their economic components: a straight debt instrument and options on X Stock.

The first problem with the bifurcation approach is that the exchange features do not qualify as separate options for federal income tax purposes. The exchange rights were not separately traded or tradeable. Certain characteristics of the embedded exchange features distinguish them from options. Unlike options, the holders of the debentures were at risk for the full principal amount of the debentures – an amount that closely approximated the value of the referenced stock at inception of the debentures – rather than just a premium amount if Taxpayer became insolvent. Taxpayer did not receive only a premium upon the issuance of the debentures but received debt proceeds that approximated the value of the X Stock.

Taxpayer's right to redeem the debentures also impacts the optionality of the embedded exchange feature. Although holders could exercise their exchange rights if Taxpayer redeemed the debentures early, a holder would be essentially forced to exercise its exchange right as a defensive measure if the stock had appreciated and Taxpayer called the debentures for redemption. Thus, holders' rights to exchange the debentures were limited in a manner that is inconsistent with holding an option, namely the exchange rights were not entirely exercisable at the discretion of the holders and it is not clear that it would be in holders' best interest to exercise whenever Taxpayer decides to redeem. See Custom Chrome v. Commissioner, 217 F.3d 1117, 1123 (9<sup>th</sup> Cir. 2000) ("because the puts were exercisable at the discretion of [holder], and it was not clear that it would have been in [holder's] interest to exercise the puts (indeed [holder] did not), the puts were pure options and not a debt instrument" and therefore subject to the investment unit rules of section 1273(c)(2)).

The second problem with the bifurcation approach is that it has been considered and specifically rejected for purposes of tax accounting under the CPDI OID rules. CPDIs are indivisible debt instruments for tax purposes. Prior to issuance of section 1.1275-4 under T.D. 8674, proposed regulations were published under 56 F.R. 8308-01, F.I. 189-84, which would have applied separate treatment for noncontingent and contingent payments. Prop. § 1.1275-4(g)(4) (February 28, 1991) provided that contingent payments "shall be treated in accordance with their economic substance as payments pursuant to one or more options or other property rights." These proposed rules would have bifurcated a CPDI into its economic components, such as an option and a debt. See also Notice 91-9, 1991-1 C.B. 316 ("the effect [of the proposed regulations] will be to divide debt instruments of this type into their component parts and to tax each component as it would have been taxed had it been issued as a separate instrument.")

These proposed regulations were subsequently withdrawn by 59 FR 4878-01, 1994-1 C.B. 785 and on December 16, 1994, new proposed regulations addressing CPDIs were published under 59 FR 64884-01, and subsequently finalized in T.D. 8674. The rules account for the treatment of a contingent payment under the noncontingent bond method, as provided in section 1.1275-4(b)(3). Under this method, the projected amount of a contingent payment is taken into account in the yield of the instrument. § 1.1275-4(b)(3); § 1.1275-4(b)(4)(ii)(C) (providing that the projected payment schedule must produce the comparable yield). In order to determine the amount of a market-

based contingent payment, section 1.1275-4(b)(4)(ii)(A) provides that if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable federal rate from the issue date to the date the contingent payment is due. Thus, the contingent payment is not a separate property right but rather is “substantially similar” to a property right. The preamble to 59 FR 64884-01 acknowledges that the pricing of an embedded property right might also differ from the pricing of a property right that was separately purchased due to “charges for financial intermediation that would not be imposed if the property right were purchased separately” but that the rules for setting a projected payment schedule “allow for substantial flexibility.” 59 FR at 64886-87. Thus, the economic value of an embedded option is not necessarily identical to an option that was purchased separately.

Since CPDIs are generally indivisible debt instruments for tax purposes, the right to a contingent payment under a CPDI is not a separate property right, such as an option. In order for the embedded exchange feature in the Exchangeable Debentures to nevertheless qualify as a QCC under section 1092(c)(4), the straddle rules would adopt a different definition of “option” from other tax rules and a different tax accounting approach from the OID rules and section 163.

Bifurcation of the Exchangeable Debentures into a straight debt instrument and an option on X Stock is not necessary for purposes of applying the straddle rules. To the contrary, under the facts of the instant case, Taxpayer’s position in X Stock substantially diminishes its risk of loss in the Exchangeable Debentures, and therefore, qualifies as a straddle for purposes of section 1092.

2. Even if the Exchangeable Debentures or the exchange features constitute call options, they are nevertheless not qualified covered call options for purposes of section 1092(c)(4).

Section 1092(c)(4)(B) provides that the term “qualified covered call option” means any option granted by the taxpayer to purchase stock held by the taxpayer (or stock acquired by the taxpayer in connection with the granting of the option) but only if –

- (i) such option is traded on a national securities exchange which is registered with the Securities and Exchange Commission or other market which the Secretary determines has rules adequate to carry out the purposes of this paragraph,
- (ii) such option is granted more than 30 days before the day on which the option expires,
- (iii) such option is not a deep-in-the-money option,
- (iv) such option is not granted by an options dealer (within the meaning of section 1256(g)(8)) in connection with his activity of dealing in options, and
- (v) gain or loss with respect to such option is not ordinary income or loss.

Section 1.1092(c)-1(b)(1), as issued under T.D. 8990, provides that in general, except as provided in paragraph (b)(2) of this section, an option is not a qualified covered call unless it is granted not more than 12 months before the day on which the option expires or satisfies term limitation and meets certain other requirements. Section 1.1092(c)-1(b)(2) extends the permitted term to 33 months provided certain other requirements are met.

Even if the Exchangeable Debentures or the embedded exchange features were deemed to qualify as options, they are not QCCs. In order to qualify under section 1092(c)(4)(B)(i), Taxpayer must show that either would have been available in an option traded on a national securities exchange at the time the debentures were issued. Taxpayer cannot show this because the a year term of the debentures is much longer than any exchange-traded option available at that time. As observed in the preamble to T.D. 8990, 2002-1 C.B. 947, which finalized section 1.1092(c)-1:

In 1984 [when the section 1092(c)(4)(B)(i) was enacted], no exchange-traded option had a term of greater than nine months. By contrast, certain exchange-traded options currently [as of 2002] may have terms of up to 33 months. In light of these changes, the IRS and Treasury have considered certain economic characteristics of qualified covered call transactions as they relate to the risk reduction effects of longer-term options.

See also H.R. Rep. 98-432, 98<sup>th</sup> Cong., 2d Sess. 1262 (1984); S. Rep. No. 98-169, 98<sup>th</sup> Cong., 2d Sess. 284 (1984) (describing exchange-traded stock options as having a maximum term of nine months). Thus, when section 1.1092(c)-1 was issued in 2002, not long after the issuance of the Exchangeable Debentures, 33 months was the maximum term of an exchange-traded option. The new regulations clarified that options with terms longer than 9 months, up to 33 months, could nevertheless qualify as QCCs. While the regulations were finalized prior to the issuance of the Exchangeable Debentures, the regulations and their preamble assist in interpreting the statute because “the meaning of the statute has been there from the time of its original enactment.” Chock Full O’Nuts Corporation v. U.S., 453 F.2d 300, 303 (2d Cir. 1971)(footnote 8, citing K.C. Davis, Administrative Law Treatise § 5.09, p. 347 (1958)).

Here, the a year period of the Exchangeable Debentures and of the embedded exchange features significantly exceeded 33 months, so neither qualify as an option traded on an SEC regulated exchange. No exchange-traded option had a term as long as that of the debentures at the time the debentures were issued. Although the embedded exchange features were literally “exchange-traded” because the Exchangeable Debentures were exchange-traded debt, this is irrelevant to the analysis because the question is whether they were similar enough to exchange-traded options, not exchange-traded debt.

Finally, the Exchangeable Debentures do not meet the requirement under section 1092(c)(4)(B) that gain or loss not be ordinary income or loss. Here, because the debentures are CPDIs, under the noncontingent bond method, all amounts paid or accrued with respect to the debentures were treated as either ordinary income or loss. When the debentures were redeemed at a premium in Year 1 by Taxpayer, the rules of section 1.163-7 applied and Taxpayer deducted the repurchase premium paid as interest, before application of sections 1092 and 263(g).

In light of the foregoing, neither the Exchangeable Debentures nor the embedded exchange features qualify as qualified covered call options under section 1092(c)(4).

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call [01203 690860](tel:01203 690860) if you have any further questions.